United States Court of Appeals

For the Ninth Circuit

WILBUR SECURITY COMPANY

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

No. 16496

BRIEF FOR PETITIONERS

Appeal from the Tax Court of the United States

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INDEX

Statutes iii

Index of Exhibits iii

Table of Cases ii

Jurisdictional Statement 1

Statement of the Case 1

Specifications of Error 7

Argument on Specification of Error 8

Conclusion 23

TABLE OF CASES

B.M.C Manufacturing Corporation, T.C. Memo Opinion, Docket No. 31588, entered April 16, 1952, 11 T.C.M. para. 376 .... 14, 16, 17

Commissioner v. John Kelly Co. (1946) 326 U.S. 521 10

Earle v. W. J. Jones & Sons, Inc. (CA, 9-1952) 200 F (2d) 846, aff'g Dist. Court of Oregon 16

Gordon, Abraham J. et. al. (CA-3, 1959) 59-2 U.S.T.C. § 9551 rev'g 17 T.C.M. 842, ... 22

Kraft Foods Co. v. Commissioner (CA-2, 1956) 232 F (2d) 118, rev'g 21 T.C. 513 14

Matthiessen, Erard A. (1951) 16 T.C. 786, aff'd (CA, 2-1952) 194 F (2d) 659 .... 11, 18

Miller, Estate of Herbert B. v. Commissioner (CA, 9-1956) 239 F (2d) 729, rev'g 24 T.C. 923 .... 10, 12, 14

New England Lime Co. (1949) 13 T.C. 799 16

Sogg, George L., T.C. Memo Opinion, Docket No. 23112, ent. October 4, 1950, 9 T.C.M. 927 aff'd (CA, 6-1952) 194 F (2d) 540 17

Tauber, Sheldon (1955) 24 T.C. 179 14

Wilbur Security Company (1959) 31 T.C. No. 92 6

STATUTES

Internal Revenue Code of 1939 Section 23(b)

Internal Revenue Code of 1954 Section 163

INDEX OF EXHIBITS

Exhibit Number	Identified	Offered in Evidence	Rejected
Joint Exhibits			
1-AA to 43QQ	71	73	
23 WW	120	121	
45-RR to 47-TT	26	26	
Petitioners' Exhibits			
44	116	117	
Deposition (No number)	73	83	

JURISDICTIONAL STATEMENT

The Tax Court of the United States, in a written opinion (31 T. C. No. 92) held adversely to Petitioners herein under date of January 30, 1959. The decision was amended February 4, 1959. The decision of the Tax Court called for a rule 50 computation and the final decision was entered March 13, 1959.

Petitioner filed a Petition for Review with the United States Court of Appeals for the Ninth Circuit on or about the 21st day of April, 1959, together with a Statement of Points Relied Upon and a Designation of the Record on Review. A Notice of Filing Petition for Review, together with a copy of Petition for Review, a copy of Designation of Contents of the Record on Review, and a copy of the Statement of Points Relied Upon were served upon the chief counsel, Internal Revenue Service, in Washington D.C. on April 21st, 1959.

The income tax returns for the periods here involved were all filed with the District Director of Internal Revenue for the State of Washington at Tacoma, Washington.

This court has jurisdiction on appeal from the decision of the Tax Court of the United States by virtue of Section 7482 of the Internal Revenue Code of 1954.

STATEMENT OF THE CASE

The Wilbur Security Company (hereinafter referred to as either the petitioner or the corporation) is a Washington corporation which has operated in the state of Washington

since March 18, 1915. During the taxable year 1953, 1954, and 1955 petitioner had the following amounts outstanding in its Bills Payable Account upon which interest was paid:

Year	Amount Outstanding	Interest Paid
1953	$552,518.40	$32,311.10
1954	552,518.40	33,151.10
1955	552,518.40	33,151.10

The interest above was taken as a deduction by the corporation on the Federal Income Tax Returns as filed for each of the said taxable years. It is this interest deduction that is here in the controversy. The respondent by a statutory notice of deficiency, disallowed the interest taken by the plaintiff on the theory that the interest expenses did not constitute interest on indebtedness (T. 9). The problem is whether the advances constitute bona fide indebtedness of the petitioner or whether in reality, such amounts constitute equity invested capital (T. 27).

Although the well worn cliche "Inadequate Capitalization" was not used by the Tax Court in arriving at their decision, the cases relied upon by the Tax Court all involve the inadequate capitalization field. The Tax Court in deciding the question found that the advances by certain individuals to the plaintiff were additional contributions to capital and that interest payments were dividends and therefore not deductible by petitioner for Federal Income Tax purposes. This decision resulted in income tax deficiencies to the petitioner for the taxable years 1953, 1954, and 1955 totaling $48,028.81.

The petitioner was organized in March 1915 at a time when the Federal Income Tax was an infant some 18 months old. The initial capital of the corporation was $25,000. This amount was paid in 1916. At the time of the organization of the corporation, the stockholders deposited with the petitioner $200,000 which amount was held in a special account known as "Special Stockholders Account". In 1915 the by-laws of the corporation provided that the amounts outstanding in the Special Stockholders Account would be transferred in proportion to the stock if any of the stock was sold. The $200,000 in the Special Stockholders Account was characterized by the parties as loans and was withdrawn from time to time (T. 152, 177). The said amount was at the risk of the business and was from time to time withdrawn (T. 154). Certainly the corporation had no thought of income taxes in 1915 and would not have needed more than $25,000 to run the business when it was formed (T. 152).

From 1915 to 1938 the corporation borrowed amounts from stockholders and from others. In 1938 the corporation had borrowings of $356,230.55 over and above the $200,000 which had been held during these years in the Special Stockholders Account. The additional borrowings were from stockholders and others who owned no stock in petitioner and the account on the petitions books was labeled, "Special Account". (T. 17, Exs. 9-I and 18-R).

In June of 1939 the Special Stockholders Account of $200,000 was paid off in full. The amounts which the petitioner had borrowed from others and the amount in the

Special Stockholders Account were consolidated into what was known on the books of the petitioner as "Special Account". The $200,000 was paid off through book entries at the request of the individual stockholders involved (T. 175).

The "Special Account" remained on the books of the corporation until 1942. In 1942 the amount of borrowing outstanding from the corporation was $549,518.40 of which approximately 50 per cent were amounts borrowed from persons who owned no stock interest in the corporation (T. 18, Exhibit 12-L).

In 1943, pursuant to a resolution of the board of trustees of the petitioner, the "Special Account" payable was changed on the books of the petitioner to "Bills Payable". Notes with a one year maturity date bearing interest at the rate of 5 per cent per annum were set up on the books of the corporation (T. 19, Exhibits 13-M, 14-N). Book entries of the corporation evidenced this change in nomenclature of the account (T. 118 and 119).

This account i.e. "Bills Payable" account, remained on the books of the petitioner until 1957 when it was changed in name only to "Notes Payable Account" by the then accountant for the corporation who deemed the usage of the words Bills Payable to be old fashioned and not in accordance with modern day accounting principles (T. 118).

It was the amount outstanding in the "Bills Payable Account" upon which the interest payments were made and which generated the present controversy. The following schedule shows the persons who were either stockholders

or noteholders in the petitioner during the taxable years 1953, 1954, 1955, and the percentage of stock and notes owned.

SCHEDULE

	1953		1954		1955	
Stockholder	Notes	Stock	Notes	Stock	Notes	Stock
Sarah Farnsworth	11.55%	36%	11.55%	36%	0	0
Grace Phillips	15.08%	0	15.08%	0	26.62%*	36%
Catherine Bernhard	4.52%	0	4.52%	0	4.52%	0
Elizabeth McPherson	.72%	2%	.72%	2%	.72%	2%
J. McPherson	26.06%	41%	26.06%	41%	26.06%	41%
J. K. McPherson	4.34%	10%	4.34%	10%	4.34%	10%
Kate McPherson	15.75%	0	15.75%	0	15.75%	0
E. H. Oswalt	1.09%	3%	1.09%	3%	1.09%	3%
G. Thompson	2.90%	8%	2.90%	8%	2.90%	8%
Julia McPherson	17.99%	0	17.99%	0	17.99%	0

*Grace Phillips acquired her stock in the petitioner August 17, 1955.

As seen from the above schedule the ratio of percentages in the stock and note account are not proportionate. In fact during 1953, 1954 and most of 1955 over 50 per cent of the advances outstanding in the Bills Payable Account were from individuals who owned no stock interest in the petitioner. In addition to this, those who did own stock in the corporation did not own notes in proportion to their stock holdings. In no instance was the amount held proportionately.

During each of the taxable years 1953, 1954, and 1955 there were notes outstanding covering the amounts in the Bills Payable Account. The notes in these years were one year notes with a provision for interest and were renewed

each year either by issuing a new note or renewing the old note.

During 1953, 1954, and 1955 petitioner had assets with a fair market value of at least $1,600,000, and surplus of over $150,000. The petitioner could have borrowed the money outstanding in the Bills Payable Account from other sources. The noteholders were not subordinate to other creditors although on one occasion they were requested to subordinate their loans and refused to do so. The noteholders intended the amounts in the Bills Payable Account to be loans and did not consider that the amounts were at the risk of the business. The noteholders who owned no stock in the petitioner did not share in the management of the petitioner nor in the profits of the petitioner.

The Internal Revenue Service upon investigation of the petitioner determined that the interest payments to the stockholders and non-stockholders alike were a disallowable deductions for federal income tax purposes. This position was a restatement of a position taken many years prior to the taxable years involved herein. The Internal Revenue Service had taken the same position in 1937 and 1938 but dropped the contention after conference with the taxpayers.

The Tax Court of the United States in its opinion (T. 50), agreed with the position taken by the Internal Revenue Service and stated as follows:

> "Looking only to the facts of the years in question, without regard to the circumstances of prior years, the Bills Payable Account might appear to be bona fide indebtedness. For each account, there existed a note,

> bearing a stated rate of interest, and payable at a fixed maturity date, one year from the date of making the note. The ownership of the stock did not continue in the same proportion to the interest in the bills payable account. Some persons owning interests in the Bills Payable Account did not own any stock, nor did they have any right to vote or participate in the management. The names on the certificates, Bills Payable, suggest an indebtedness rather than capital investment. Finally, the declared intent of the petitioner as set out in the minutes of the Directors Meeting would suggest the existence of an indebtedness. However, we are satisfied that to accord determinative weight to these apparent indicia of an indebtedness without consideration of the events and circumstances of prior years, where material, would distort the true facts and obscure the reality of the arrangement here involved."

The Tax Court of the United States, as can be seen from the above quotation, felt that if the years in question were important the indicia of bona fide indebtedness as set out in the stated cases was apparent but that in this particular case ancient history was far more determinative of the intent of the parties than the years in question.

Based upon substantive case law of the United States Court of Appeals for the Ninth Circuit and the facts of this case the Tax Court clearly erred.

SPECIFICATIONS OF ERROR

I.

The Tax Court of the United States erred in holding that the amounts which petitioner had outstanding in its Bills Payable Account during each of the taxable years 1953, 1954, and 1955 represented equity invested capital rather

than loans and that the interest payments made by petitioner thereon during each of the said taxable years were not deductible in arriving at taxable income.

ARGUMENT

The Tax Court Erred in holding that the amounts outstanding in the Bills Payable Account of the Petitioner for the taxable years 1953, 1954, and 1955 represented equity invested capital and not loans.

In the instant case the petitioners had advances outstanding in the total amount of $552,518.40 during the taxable years 1953, 1954, and 1955. The Internal Revenue Service disallowed as deductions for tax purposes the interest payments on these notes during said years on the theory that the indebtedness represented equity capital and not loans. The Tax Court of the United States agreed with this holding (T. 26). The Tax Court decision, for the reasons set forth below, goes further than any other Court holding in the so-called inadequate capitalization field.

In so holding the Tax Court said:

> "Looking only to the facts of the years in question, without regard to the circumstances of prior years, the Bills Payable Account might appear to be bona fide indebtedness. For each account, there existed a note, bearing the state's rate of interest, and payable at a fixed maturity date, one year from date of making the note. The ownership of the stock did not continue in the same proportion to the interest in the Bills Payable Account. Some persons owning interest in the Bills Payable Account did not own any stock, nor did they have any right to vote or participate in the management. The names on the certificates, Bills Payable,

> suggest an indebtedness rather than capital investment. Finally, the declared intent of the petitioner as set out in the minutes of the Directors Meeting would suggest the existence of an indebtedness. However, we are satisfied that to accord determinative weight to these apparent indicia of an indebtedness without consideration of the events and circumstances of prior years, where material, would distort the true facts and obscure the reality of the arrangement here involved." (T. 50).

The Tax Court forgot to add that over 50 per cent of the amounts outstanding in the Loan Account during the years here involved were from individuals who had no right to vote, no voice in management, and did not share in corporate profits. The fact that these people were related to the stockholders should cast no shadow on the declared intent. The Petitioner knows of no family attrition rules which would apply in the so-called inadequate capitalization field.

The events and circumstances of prior years which the Tax Court decided should be accorded great weight hark back to the very birth of the Federal Income Tax Law. The corporation involved herein was formed in 1915 at a time when the federal income tax was a mere infant preparing to celebrate its second birthday.

The Tax Court in relying upon ancient history and disregarding facts that are apparent in the taxable years have placed a fence around corporation loans. If the Tax Court holding herein (i.e. that in determining the character of advances for tax purposes you looked to the circumstances surrounding the creation of the corporation and disregard reality in the years in question), is sustained it will mean that

every corporation advance is cast at the beginning. Later events will be entirely immaterial. Stated another way, can a corporation thin at the outset ever gain weight?

The question of whether amounts advanced to a corporation constitute equity capital or indebtedness is a question of fact. The whole concept had its birth in some very unfortunate dicta in *Commissioner v. John Kelley Co.* (1946) 326 US 521. It would seem that people should be allowed to cast advances to a corporation in any manner that they seem fit. In this age of the tail wagging the dog for tax purposes such is not the case. This Circuit Court of Appeals in *Estate of Herbert B. Miller v. Commissioner* (CA, 9-1956) 239 Fed (2d) 729 reversing 24 T.C. 923, commented as follows:

> "We know of no rule which permits the commissioner to dictate what portion of the corporation's operations shall be provided for by equity financing rather than debt."

The above quotation is true in cases where corporations were formed and planned with tax consequences in mind. It should also be true, in the instant case, where the corporation was formed 30 years prior to the unfortunate dicta in the *Kelley* Case referred to above.

The tests used by the Courts in determining the question involved herein are well set forth in the Tax Court opinion (T. 49) wherein the court set out 10 separate determining factors: 1. The name given to the certificates evidencing the indebtedness. 2. The presence or absence of a maturity date. 3. The source of the payments. 4. The right to enforce

the payment of principal and interest. 5. Participation in management. 6. A status equal to or inferior to that or regular corporate creditors. 7. The intent of the parties. 8. Capitalization. 9. Identity of interest between creditor and stockholder. 10. Payments of interest only out of dividends.

In addition to the above ten factors set forth by the Tax Court, the Courts have also looked to whether or not the corporation could have obtained loans from outside lending institutions, See *E. Erard A. Matthiessen* (1951) 16 T.C. 786 affirmed (CA-2, 1952) 194 Fed (2d) 659.

The best way to approach the tests, referred to as important factors by the Tax Court set forth above, is to compare each test with the facts in the instant case.

There is no question that Notes evidencing the indebtedness were issued in the instant case and the notes had none of the indicia of equity ownership. (Test No. 1, above). The notes had fixed maturity dates and interest was paid. (Test No. 2, above). The notes in all the years in question were either reissued or renewed. The Tax Court in its opinion has found no quarrel with this contention (T. 50).

Test No. 3, above, concerns the source of the payment. If this means the source of the original loan the amounts in the Bills Payable Account in the years in question were not from earnings. The 1915 advances were paid off in 1938. The corporation had earnings in each of the taxable years and paid, in addition to the interest, dividends and salaries. Over 50 per cent of the interest was paid to non-stockholders who received no dividends since they did not share in

the corporate profits. In this regard what this Court said in the *Miller* case supra seems appropriate.

> "It is true that it was contemplated that the notes would be paid out of the earnings of the corporation, but the most excellent record of the past earnings of this same business was such that this was the reasonable contemplation. Many borrowers rely upon expected earnings for payments of their debts. We cannot see any justification for inferring that a promissory note is unreal and not representative of the actual arrangement merely because the maker expects to pay out of future earnings."

The right to enforce the payment of principal and interest is the next factor eluded to by the Tax Court (Test No. 4, above). As applied here the principal amount of the debt was in three instances completely paid off subsequent to the taxable years involved herein. J. K. McPherson's notes were paid off in 1957 although he remained a stockholder (T. 89). In addition to J. K. McPherson, G. Thompson and Mr. Oswald withdrew the amounts which they had outstanding in the Bills Payable Account, although both were stockholders (T. 161-162). The facts concerning the above withdrawals, although clearly a part of the record were not included in the Tax Court findings. Grace Phillips withdrew amounts from the Bills Payable Account. On one occasion the withdrawal was $14,000 and in another instance the withdrawal was $69,000 (Transcript p. 45).

It has been previously stated for 1953, 1954, and most of 1955 over 50 per cent of the amounts outstanding in the Bills Payable Account were from individuals who owned no stock interest in the petitioner. These individuals had no

voice in management (Test No. 5, above). The Tax Court in its opinion recognized that the non-stockholders had no right to vote or participate in corporate management (T. 50). The non-stockholder did not participate in the fluctuation of the stock value that took place over the years and intended the Bills Payable amount as loans specifically not at the risk of the business (T. 94, 167).

In the instant case the amounts in the Bills Payable Account were not subordinate to other corporate creditors (Test No. 6, above). On one occasion the non-stockholders of the corporation were requested to subordinate their indebtedness to other creditors and refused to do so (T. 159 and 89).

The individual certainly intended the Bills Payable to be loans (Test No. 7, above). There is no evidence in the record contra to this conclusion (T. 129, 160).

The next test spoken of, above (Test No. 8), is capitalization. In its opinion the Tax Court in determining ratios used 1915 figures disregarding the fact that in the taxable years involved the corporate assets surplus and paid in capital completely outweigh the debt (T. 51). The Tax Court ratio relied upon in 1915 is 8 to 1. The real ratio is about 5 to 1 in reverse i.e. the corporation in the taxable years had indebtedness of approximately $552,000 but assets of over $1,600,000.

The case law in the inadequate capitalization field substantiates the fact that real values must be used in computing ratios and that the values must be determined for

the years involved e.g. 1953, 1954, 1955 here rather than 1915.

In *Sheldon Tauber,* (1955) 24 T.C. 179 the Tax Court stated as follows:

> "Thus, the initial capital of the corporation was not merely the $100 of cash paid in by the four individuals and shown as capital in the books of the corporation, but was a much larger amount not shown on its books which was nevertheless available as working capital. The total capital of new corporation could not fairly be called 'thin'."

In *B. M. C. Manufacturing Corporation,* T. C. Memo opinion, Docket No. 31588 entered April 16, 1952, 11 T.C.M. 376 the Tax Court said:

> "As to the capitalization, respondent draws no distinction between the petitioner's condition at the time of the issuance of the two sets of debentures. Looking at the facts as of the date of the second issue, the contention is clearly unsupportable. By that time there was at the risk of the business and a part of petitioner's capital structure some $116,000 of accumulated earnings more than the entire $100,000 of debentures issued at that time."

In *Kraft Foods Company v. Commissioner* (CA-2, 1956) 232 Fed (2d) 118 reversing 21 T.C. 513 the Circuit Court of Appeals for the Second Circuit said:

> "We think it obvious that in the determination of debt-equity ratios, real values rather than artificial par and book values should be applied."

In *Estate of Herbert B. Miller* supra this Circuit Court of Appeal said:

"The Tax Court placed much emphasis upon what it called 'an absurdly low capitalization' of the corporation. While the Court expressly disclaimed any intent to decide whether inadequate capitalization in and of itself would authorize the court to disregard as genuine the purported indebtedness, it did discuss at length cases dealing with the so-called 'thin' capitalization question. The findings of the Tax Court referred to the declared value of $1,050 set upon the organization of the Oregon Corporation.

"The finding, however, fails to note that the best available evidence upon the subject, namely, that furnished by the estate tax appraisal previously referred to, indicates that the declared value had no relation whatsoever to the real values of the corporate stock. When these facts are taken into consideration, it seems apparent that there was no disportionate ratio of debt in capital in this case. If the capital stock was worth $100,000, or thereabouts, as has been indicated, an indebtedness of $174,000 would not be disportionate, and no such ratio has ever been held to create a fatally thin capitalization."

From the above cited cases, it can be seen that in computing the ratio of debt to equity realism is indeed a factor. Here the petitioner was not undercapitalized. Probably the best illustration that the petitioner had ample assets to cover the debt is the fair market value placed on the stock when Elizabeth McPherson died in 1953. The record shows that stock for estate tax purposes was valued by the Internal Revenue Service and the Estate of Elizabeth McPherson at $2,300 a share. This means that the corporate assets (over and above debt) were at least $575,000 (i.e. 250 shares @ $2,300 a share).

Stock values on or about the crucial periods have been referred to in the decided cases and held material. For example, in the *Estate of Herbert B. Miller* supra, this court said:

> "The general favorable earning capacity of the corporation and its business is indicated by the fact that in the estate of Herbert Miller his 100 shares of the capital stock of Miller Paint Company, Inc., were valued for estate tax purposes at $347.78 per share; this as of February 13, 1948 approximately a year and a half after the transfer to the corporation."

The petitioner herein was adequately capitalized at the time the instant loans were made. The *B.M.C. Manufacturing Corporation* case, supra, stands for the proposition that you must look the capital structure at the time the loan is made and not when the corporation is organized. See also *Earle v. W. J. Jones and Sons, Inc.* (CA-9, 1952) 200 Fed (2d) 846, affirming District Court of Oregon.

Identity of interest between creditor and stockholders i.e. pro rata holdings of stock and indebtedness, has always been an extremely important factor in the determination of whether an advance to a corporation represents equity capital or a loan. (See Test No. 9, above). This test has indeed been considered important. In *New England Lime Co.* (1949), 13 T.C. 799 the Tax Court allowed an interest deduction on certain debentures of the corporation and in so holding commented at length upon the favorable fact that stockholders did not hold the debentures in uniform proportion to their stock.

In *George L. Sogg* T.C. Memorandum opinion, Docket No. 23112 decided October 4, 1959 9 T.C.M. 924 affirmed (CA6-1952) 194 Fed (2d) 840, the petitioner was denied an interest deduction and the fact that the stockholdings and the loans were pro rata was deemed a material factor. In *B. M. C. Manufacturing Corporation* case, supra, the Tax Court in considering the question of adequate capitalization said:

> "And finally perhaps most significantly, the interest was not distributed to the petitioners stockholders in anything like the proportions in which they held it stock. In fact the largest interest payment was made to a non-stockholder of petitioner, . . ."

Applied to the instant case this test (Test No. 9) leaves no doubt that the interest deductions taken by the petitioner were proper. When the non-pro rata aspect is considered with the fact that over half (50 per cent) of the amounts outstanding in the Bills Payable Account during the years have included were from individuals who owned no stock it would seem that the petitioners action in deducting interest payments was indeed proper. Certainly individuals who owned no stock, had no voice in the management of the corporation and did not share in the corporate appreciation or profits could not be considered stockholders. The testimony was to the effect that the stock increased and decreased in value. The amounts outstanding in the Bills Payable Account remained constant. The earnings of the Corporation had no bearing upon the interest payments during the years involved herein. The non-stockholders had no voice in the corporate affairs.

Payment of interest only out of dividends is the last factor spoken of by the Tax Court (Test No. 10, above). As applied to the instant case, the petitioner always paid substantial dividends. Naturally the amount of interest was paid from earnings. It would seem that this should not militate against a holding of debt as opposed to capital contribution.

When the instant facts are compared to the ten (10) important tests set forth in the Tax Court opinion it's hard to imagine how the Tax Court arrived at its decision. In every instance the facts of the case meet the tests favorably yet the Tax Court has found it necessary to completely overlook the facts as they existed in the years material hereto and seek out facts that are based principally on ancient history (i.e. 1915 to 1938) choosing in so travelling to ignore the change that took place within the petitioner in the interim.

The important fact that the Tax Court didn't mention in setting out the ten fateful factors above i.e. whether or not the corporation could have gained the advanced from outside sources, is also favorable to the petitioner. In the *Matthiessen* Case, supra, the Court said:

> "The possibility is remote indeed that a disinterested lender of money would have made the initial unsecured loan of $20,000 to Tiffany in order to provide that corporation with the working capital necessary to embark on a speculative building project. It would be even more improbable that such a lender would continue to advance funds for a venture such as Tiffany which was showing an increased deficit in each year."

The instant corporation could easily have borrowed money from outside sources. The National Bank of Com-

merce in Seattle, Washington offered to loan the corporation enough money to completely pay off the Bills Payable Account. Any lending institution would have gladly loaned the corporation enough money to pay the holders of the Bills Payable Account. The corporation had assets of over a million and a half dollars and no liabilities other than that outstanding in the Bills Payable Account. The chief appraiser for the Equitable Life Insurance Society of the United States testified that he would have recommended a loan in excess of $500,000 to this corporation. This is substantial evidence the amount in the Bills Payable Account was a loan and not a contribution to capital.

The Tax Court in its opinion dwelt at length on ancient history (T. 50, 51). Much is made of the fact that in the earlier years (with regard only to the $200,000 in the Special Stockholders Account) no notes were in evidence. Again the years 1915 and not the taxable year.

In 1939 the Special Stockholders Account was transferred to the Special Account. The tax court in its opinion states in effect that this lacks substance and therefore did not alter the identity of the account in any manner. The Tax Court said: (T. 52).

> "However, aside from the resolution passed at a meeting of the Stockholders in 1939 there is no record of the amounts being distributed in fact to the interested parties, but there was merely an entry on the books whereby the Special Account was credited and the Special Stockholders Account was debited."

The petitioner asks what other evidence could there be? Is it necessary in such a situation to withdraw money and reloan? The minutes stand on their own feet in this situation and fully set forth the intent of the parties (Ex. 10-J, 11-K).

The Tax Court speaks of the corporate resolution calling for $800 in the Special Account for each share of stock. (T. 53). The record is quite plain that the resolution was not followed after the Special Stockholders Account became extinct in 1938. J. K. McPherson for example knew nothing of this article in the by-laws until the Internal Revenue Agent pointed it out to him in 1953 (T. 92).

The Tax Court's opinion states as follows (T. 53):

> "In 1943, petitioner converted the Special Account to the Bills Payable Account at the advice of its accountant. For the first time notes were made reflecting the amounts in the account. These notes bore a stated rate of interest, and a maturity date of one year from the date they were made. However, these notes remain in the possession of the petitioner and no stockholder saw them although some knew of their existence. At the end of each year either the notes were marked paid by one of the petitioners officers and new notes issued for the same amount, or the old notes were simply renewed. These transactions were accomplished without the concurrence of those other than the stockholders, owning interest in the Bills Payable Account."

J. K. McPherson testified that the Board of Directors of the corporation requested that notes be renewed (T. 90, 91). The procedure for the renewal of the notes in 1953 was brought out quite clearly on cross examination (T. 100, 101, 102). The notes were renewed automatically but there were discussions leading up to the renewal of the notes (T.

103). Interest was paid by crediting the individual accounts of the stockholders and non-stockholders (T. 102).

As to the variation of interest rate referred to by the Tax Court in its opinion (T. 53), the witnesses stated the interest rate depended upon the demand for money and the interest rate was determined by the noteholders (T. 182). It is not known where the record supports the assertion that the notes were handled without the concurrence of those other than the stockholders owning interest in the Bills Payable Account.

It must be remembered that the over all amount outstanding in the Bills Payable Account upon which interest was paid in 1953, 1954, and 1955 was $552,518.40. The majority of the Tax Court Opinion is concerned only with the original $200,000. The excess i.e. $352,518.40 of which most was owned by non-stockholders is not mentioned as such. The Tax Court states in distinguishing the non-stockholders (T. 55):

> "Aside from the absence of voting rights and participation in management, there were no distinctions between the $200,000 account and the Special Account."

The only other difference that could be present under the circumstance would be that the noteholders, who owned no stock, did not participate in the income of the petitioner. The fact that they did not so participate is clearly a statement of fact supported by the record with no evidence to show otherwise. (T. 95, 161).

The Tax Court of the United States, in the instant case, has, contra to its previous views, completely overlooked the record as to intent of the parties. There is nothing in the said record which would overcome the assertion that the parties intended the amounts outstanding in the Bills Payable Account to be loans. The record clearly shows that the parties did so intend. (T. 87, 88, 129, 152). It would seem that the Tax Court is not free to disregard relevant uncontroverted evidence. In *Abraham J. Gorden* et. al. (CA-3, June 1959) reported at 59-2 U.S.T.C. §9551, rev'g Tax Court Memorandum decision 17 T.C.M. 842 the court said:

> ". . ., we think that the Tax Court arbitrarily disregarded unchallenged, competent and relevant evidence in the record which was inherently credible."

In the instant case the Tax Court has disregarded all the evidence concerning intent and substituted in lieu thereof corporate transactions which are so far removed from the years in question as to be completely immaterial.

The noteholders of the petitioner all intended the amounts on deposit in the Bills Payable Account to be loans. The petitioner was not inadequately capitalized and none of the well worn criteria for determining "equity as opposed to debt" have been violated under the instant set of facts. Notes with a definite maturity date and calling for a fixed rate of interest were issued by appropriate corporate authority. The interest was paid throughout the years involved herein. The holders of the amounts in the Bills Payable Account refused to subordinate their loans to other credi-

tors. The noteholders and the stockholders were disportionate and over one-half of the amounts in the Bills Payable Account represented advances from parties who had no stock interest in the corporation. The factors set forth in the decided cases, and specifically set out in the Tax Court opinion, indicate that the parties intended the amounts outstanding in the Bills Payable Account to be loans not at the risk of the business.

The Tax Court of the United States has taken, in the instant holding, one giant step further in making all advances to a corporation equity as opposed to loans. The holding is in error.

CONCLUSION

The Tax Court of the United States has erred in the instant case in their holding that the amounts outstanding in the petitioner's Bills Payable Account represented equity invested capital and not loans. The Tax Court opinion should therefore be reversed.

Respectfully submitted,

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